Michael H. Bierman, State Bar No. 89156
Michael E. Pappas, State Bar No. 130400
LUCE, FORWARD, HAMILTON & SCRIPPS LLP
601 S. Figueroa, Suite 3900
Los Angeles, California 90017
Telephone: 213.892.4992
Facsimile: 213.892.7731
E-Mail: mbierman@luce.com
mpappas@luce.com

Attorneys for Plaintiff and Intervenor, National Credit Union Administration Board As Conservator For Western Corporate Federal Credit Union

UNITED STATES DISTRICT COURT

CENTRAL DISTRICT OF CALIFORNIA

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| NATIONAL CREDIT UNION ADMINISTRATION BOARD AS CONSERVATOR FOR WESTERN CORPORATE FEDERAL CREDIT UNION,<br>Plaintiff,<br>v.<br>ROBERT A. SIRAVO, TODD M. LANE, ROBERT J. BURRELL, THOMAS E. SWEDBERG, TIMOTHY T. SIDLEY, ROBERT H. HARVEY, JR., WILLIAM CHENEY, GORDON DAMES, JAMES P. JORDAN, TIMOTHY KRAMER, ROBIN J. LENTZ, JOHN M. MERLO, WARREN NAKAMURA, BRIAN OSBERG, DAVID RHAMY and SHARON UPDIKE,<br>Defendants. | Case No.: CV10-01597 GW (MANx)<br><br>**OPPOSITION OF PLAINTIFF NATIONAL CREDIT UNION ADMINISTRATION BOARD AS CONSERVATOR FOR WESTERN CORPORATE FEDERAL CREDIT UNION TO DIRECTORS' MOTION TO DISMISS FIRST AMENDED COMPLAINT**<br><br>**Date: December 20, 2010**<br>**Time: 8:30 a.m.**<br>**Judge: Hon. George Wu** |

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# INTRODUCTION

The director defendants in this action (collectively, the "Directors") and defendant Robert Burrell ("Burrell") have moved to dismiss the First Amended Complaint filed in this action by the National Credit Union Administration Board as Conservator for Western Corporate Federal Credit Union (the "NCUA") on three primary grounds. None supports the granting of the motion.

First, the Directors and Burrell argue they are shielded from liability for breach of fiduciary duty by the California business judgment rule. That rule, codified in California Corporations Code § 7231, imposes a duty on directors to act with the care of an ordinarily prudent person, while it insulates directors from liability for poor business judgments that are made exercising due care and in reliance on information provided by others. The moving defendants assert that the allegations of the First Amended Complaint do not rebut the presumption that their conduct is protected by the business judgment rule.

The First Amended Complaint alleges facts that would permit a finder of fact to make the following determinations. The Directors caused or allowed WesCorp to transform its investment portfolio from a relatively safe repository for its members' excess funds into a cash machine, generating ever-increasing amounts of investment income to support WesCorp's increasing operating expenses and to justify substantial compensation increases for WesCorp's senior executives. To generate increased investment income, the Directors directed or allowed WesCorp to significantly increase its investment in relatively riskier "private label" mortgage backed securities ("MBS") and to borrow substantial sums to increase the amount of the investment. They did so without weighing the increased risks of this change in the investment portfolio against the increased income generated and without obtaining the information necessary to do so. They approved budgets that mandated increased investment income without evaluating the increased investment risk that the budgets required, without obtaining the information necessary to do so, and

without considering or adopting any safeguards to mitigate the increased risk. The Directors were responsible for establishing concentration limits for WesCorp's investment portfolio. The concentration limits they set for private label MBS permitted WesCorp to invest its entire portfolio in those securities.

The Directors caused or allowed WesCorp to continue seeking increasing investment income even after learning that changes in the market required WesCorp to purchase increasingly risky MBS investments in order to maintain the same amount of investment income, let alone increase it. To obtain the investment income required by its budget, WesCorp increasingly purchased MBS based on Option ARM mortgage collateral and lower tranche MBS, both of which were relatively riskier than most of WesCorp's private label MBS. Nonetheless, the Directors did not consider the imposition of concentration limits for those types of MBS, despite their inherent riskiness, and they did not inform themselves about (or require WesCorp's management to track) the growing concentrations of these types of securities in WesCorp's investment portfolio. As a result largely of its investments in Option ARM and lower tranche MBS, WesCorp was required to recognize losses of $6.8 billion in 2009 and it failed.[1]

These alleged facts and the inferences that may fairly be drawn from them rebut any presumption that the business judgment rule insulates the Directors' conduct in this case. Nothing in the First Amended Complaint compels the conclusion that the Directors' alleged acts and omissions were the result of each of the Directors acting with the care required by Section 7231 and relying on information provided in accordance with that statute. The Directors' arguments that the allegations of the First Amended Complaint are not sufficient to overcome the presumption are based on a selective distillation of those allegations, drawing inferences in favor of the Directors and not in favor of the NCUA. Under the

[1] On October 1, 2010, the NCUA Board ordered WesCorp to be placed into liquidation.

standards applicable to motions under Rule 12(b)(6), the Directors' motion to dismiss the breach of fiduciary duty claim must be denied.

The other pleading deficiencies the Directors assert for the breach of fiduciary duty claim are likewise meritless. Breach of fiduciary duty by directors does not require an enhanced pleading standard or allegations that the conduct at issue was irrational or overreaching or that it violated the duty of loyalty.

Burrell's contentions that as an officer of WesCorp he is entitled to the protection of the business judgment rule and that the First Amended Complaint does not sufficiently allege his involvement are both incorrect.

Second, the moving defendants contend that the NCUA's statutory claim for gross negligence under 12 U.S.C. § 1787(h) cannot be brought in California because (1) the liability standard under California is stricter than gross negligence and (2) California does not recognize the tort of gross negligence. Section 1787(h) authorizes the NCUA to bring damages claims for breach of a gross negligence liability "floor" against credit union directors and officers. The moving defendants' contentions that the NCUA cannot bring this statutory claim in California are not supported by the language of the statute, and they run counter to the legislative intent of the statute as recognized by the United States Supreme Court.

The moving defendants also contend that the First Amended Complaint does not allege facts establishing gross negligence. Whether the acts and omissions alleged in the First Amended Complaint rise to the level of gross negligence as alleged is an issue of fact, to be determined on the evidence and not the pleadings.

Third, three directors contend that the applicable limitations periods for the First and Second Claims for Relief are two or three years; they expired before WesCorp failed; and the claims cannot be resurrected. These directors acknowledge the binding Ninth Circuit case law holding that the limitations period for the breach of fiduciary duty claim is four years, making that claim timely for all defendants. The statute of limitations for the Section 1787(h) claim is set by federal law, not

state law. That claim is not subject to the "no-resurrection" rule because it was not a claim assigned by WesCorp by operation of law. It is therefore also timely.

The thrust of the Directors' motion is that the Directors were well meaning and diligent volunteers whom the NCUA has made scapegoats because it needs someone to blame. The NCUA respectfully submits that the evidence will prove otherwise. This will be one of the issues to be determined at trial. It cannot be decided as a matter of law based on the allegations of the First Amended Complaint.

## THE ALLEGATIONS OF THE FIRST AMENDED COMPLAINT

WesCorp was the largest non-profit "retail" corporate credit union in the United States. First Amended Complaint ("FAC") ¶¶ 24, 37. A retail corporate credit union is a non-profit credit union whose members are themselves credit unions. *Id.* Profit maximization was not WesCorp's mission, and its structure was designed to maximize member service over profits. FAC ¶ 40. WesCorp provided its members a place to prudently invest their excess funds, a variety of "back office" banking services and a ready source of liquidity. FAC ¶ 39. WesCorp's members, particularly its many small credit union members, depended on WesCorp for services, liquidity and safe investment of excess funds. FAC ¶ 42-43.

In about 2002, WesCorp embarked on an aggressive plan to increase the yield in its investment portfolio by purchasing an increasing amount of private label MBS, rather than less risky U.S. agency securities. FAC ¶ 50. From December 2002 to December 2007, the concentration of U.S. agency MBS in WesCorp's investment portfolio dropped from 17% to 4% while the concentration of higher-yielding private label MBS increased from 72% to almost 95%. *Id.*

To further increase investment income, WesCorp borrowed substantial sums of money to purchase additional private label MBS. FAC ¶ 49. Between January 2002 and January 2004, WesCorp's borrowings increased from \$420 million to \$1.28 billion. From January 2004 to November 2008, WesCorp's borrowings increased 472% to \$7.3 billion. *Id.*

Although WesCorp increased the investment risk in its portfolio as it increased its investment income, it did not increase its capital base to compensate. FAC ¶ 51. Its officers used the increased investment income to justify substantial increases in compensation for WesCorp's top executives, including an increase in the salary and bonus compensation of defendant Robert A. Siravo ("Siravo") from $350,000 (annualized) in 2002 to almost $992,000 in 2008. FAC ¶ 53.

Each year, the Officer Defendants proposed and the Director Defendants adopted a budget for WesCorp for the following year. FAC ¶ 65. The budgets directed that WesCorp increase the investment yield and income earned by its portfolio. FAC ¶ 66. However, the Directors adopted the budgets without any information about how the composition of WesCorp's investment portfolio would need to change to achieve the net interest income projected in the budgets. FAC ¶ 65. The directors thus adopted budgets directing WesCorp's management to earn increasingly aggressive yields on its investment portfolio without the information necessary to weigh the increased risk against the increased income being generated. Burrell and WesCorp's Investment Department were responsible for ensuring that WesCorp's investments earned the returns required to meet WesCorp's budget for investment income and net interest income. FAC ¶ 67.

During the same period, the investment spreads were shrinking for the securities WesCorp was purchasing, and the yields for any particular level of risk were decreasing. FAC ¶ 55. WesCorp was therefore required to purchase increasingly risky MBS to obtain the income required by its budgets. It did so by purchasing large numbers of Option ARM MBS.[2] FAC ¶ 56, 60. WesCorp began

[2] Option ARM MBS are based on Option ARM loans, which allow the borrower to make substantially below-market monthly payments for the first years of the loan, after which the monthly payments "reset" and increase drastically, frequently more than doubling. Many Option ARM loans were made without verifying the borrower's ability to make the monthly payments. Many were made to borrowers who could try afford the initial below-market monthly payments but not the regular monthly payment due after the loan reset. FAC ¶ 59.

purchasing Option ARM MBS in 2005. In 2006, 47% of its investment portfolio purchases were Option ARM MBS. By 2007, that number had risen to 57%, and Option ARM MBS made up 37% of WesCorp's investment portfolio. FAC ¶ 60.

WesCorp also increased the risk in its portfolio by purchasing MBS from lower tranches, which would absorb any losses in the mortgage pools before the higher tranches and therefore had a higher risk and paid a higher yield. FAC ¶ 61. In 2002, more than 95% of the MBS WesCorp purchased were from a "senior" or higher tranche. By 2007, the percentage had dropped to less than 50%. FAC ¶ 63.

The Directors were charged with adopting prudent concentration limits to ensure that WesCorp's investment portfolio was properly diversified. FAC ¶ 68. From 2004 on, WesCorp's private label MBS concentration limits were meaningless – they were so high that they permitted WesCorp to invest its entire portfolio in that one form of security. FAC ¶ 69. In addition, the Directors never considered or adopted any concentration limits for Option ARM MBS, a new form of MBS that WesCorp was purchasing heavily. FAC ¶ 71. The Directors did not require or obtain information allowing them to monitor the concentration of Option ARM MBS in WesCorp's investment portfolio. *Id.* Similarly, they did not require or obtain the information required to monitor the concentration of MBS by tranche position. *Id.* Without such tracking and reporting, WesCorp and the Directors were unable to monitor or control the risks posed by the concentration of Option ARM MBS and lower tranche MBS in WesCorp's portfolio. FAC ¶¶ 71-72.

Beginning as early as March 2005 and continuing through 2006, the Directors were informed that (1) investment spreads were tightening significantly, FAC ¶ 75; (2) "good" investments were becoming increasingly hard to find, *id.*; (3) interest rates were beginning to rise, FAC ¶ 77; and (4) housing activity was slowing, *id.* Notwithstanding these trends, the Directors took no steps to curtail WesCorp's purchases of Option ARM MBS or lower tranche MBS. *Id.*

WesCorp was required to recognize investment losses of $6.872 billion as of December 31, 2008. Of these losses, more than $4.683 billion resulted from Option ARM MBS WesCorp purchased in 2006 and 2007. Had WesCorp imposed the same concentration limit on its Option ARM MBS as it did on its CDO MBS, another form of risky MBS, its losses on those securities would have been limited to less than $200 million. FAC ¶ 80.

The First Amended Complaint alleges that the Directors breached their fiduciary duty of care by, among other things, embarking on a growth and investment strategy dependent on massive borrowing without any information on the increased risks it created; failing to impose a meaningful concentration limit for investments in private label MBS; failing to impose any concentration limits on WesCorp's investments in particular forms of MBS, including Option ARM MBS; failing to monitor or impose concentration limits on WesCorp's investments in lower tranche position private label MBS; raising concentration limits and setting and approving budgets based on desired yield without consideration of the attendant risks; failing to reevaluate WesCorp's strategy of investing heavily in private label MBS in light of changing economic conditions; and allowing WesCorp to develop a large concentration of Option ARM MBS in its investment portfolio. FAC ¶ 114.

The First Amended Complaint alleges that the Directors and Officers were grossly negligent (1) in allowing WesCorp to pursue a highly leveraged strategy of investing in private label MBS without understanding the risks of a high concentration of such securities in its portfolio and without taking steps to mitigate those risks through appropriate concentration limits and investment policies; (2) in essentially ignoring the prospect that real estate values could decline; and (3) in the acts and omissions that are also alleged to be breaches of the fiduciary duty of care. FAC ¶¶ 120, ¶121.

## APPLICABLE LEGAL STANDARD

Dismissal under Rule 12(b)(6) for failure to state a claim is warranted only where the complaint does not allege a claim supported by a cognizable legal theory or if the complaint does not allege sufficient facts in support of a cognizable legal theory. *See Balistreri v. Pacifica Police Dep't*, 901 F.2d 696, 699 (9th Cir. 1988).

When considering a motion to dismiss under Federal Rule of Civil Procedure 12(b)(6), the court must accept as true all of the factual allegations set out in plaintiff's complaint and draw inferences from those allegations in the light most favorable to plaintiff. *Sprewell v. Golden State Warriors*, 266 F.3d 979, 988, amended on other grounds, 275 F.3d 1187 (9th Cir. 2001). If a complaint "pleads factual content that allows the court to draw the reasonable inference that the defendant is liable for the misconduct alleged," the complaint survives a motion to dismiss. *Ashcroft v. Iqbal*, __ U.S. __, 129 S. Ct. 1937, 1949, 173 L. Ed. 2d 868 (2009). Motions to dismiss for failure to state a claim are therefore rarely granted. *Gilligan v. Jamco Development Corp.*, 108 F.3d 246, 249 (9th Cir. 1997).

## LEGAL ARGUMENT

### I. THE BUSINESS JUDGMENT RULE DOES NOT ELIMINATE THE BREACH OF FIDUCIARY DUTY CLAIM AGAINST THE DIRECTORS.

#### A. Section 7231 Imposes A Duty Of Care On Directors.

The part of the California business judgment rule that imposes personal liability on directors is codified in California Corporations Code § 309 for for-profit corporations and in California Corporations Code § 7321 for nonprofit mutual benefit corporations.[3] Corporations Code § 7231 applies in this case.[4]

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[3] The business judgment rule has a second component that "shield[s] from scrutiny qualifying decisions made by a corporation's board of directors." *Lamden v. La Jolla Shores*, 21 Cal. 4th 249, 257, 259 (1999); *Lee v. Interinsurance Exchange of the Automobile Club of Southern California*, 50 Cal. App. 4th 694, 714 (1996). That component is not at issue in this motion.

[4] Under California Financial Code § 14002.5, California's Nonprofit Mutual Benefit Corporation Law is generally applicable to credit unions.

Section 7231 does three things. First, subdivision (a) imposes a duty to act "with such care, including reasonable inquiry, as an ordinarily prudent person in a like position would use under similar circumstances." Second, subdivision (b) entitles a director to rely on certain information furnished by others specified in the statute, provided "the director acts in good faith, after reasonable inquiry when the need therefor is indicated by the circumstances and without knowledge that would cause such reliance to be unwarranted." Finally, subdivision (c) insulates from liability any person "who performs the duties of a director in accordance with subdivisions (a) and (b)."

The business judgment rule, as codified in Section 309 (and 7231) "incorporates the concept of a director's immunity from liability for an honest mistake of business judgment with the concept of a director's obligation of reasonable diligence in the performance of his or her duties." *Gaillard v. Natomas*, 208 Cal. App. 3d 1250, 1264 (1989). Section 7231 thus protects disinterested directors against liability for carefully made decisions that turn out badly. It does not eliminate directors' liability for breach of the duty of care.

In their motion, the Directors studiously ignore the duty of care imposed by Section 7231(a). They assert that the California business judgment rule "insulates directors from liability for simple negligence," and creates a presumption of sound business judgment that "can be rebutted only by a factual showing of fraud, bad faith or gross overreaching." Motion at 7:4-5. The cases relied on by the Directors do not read the duty of care out of Section 7231 or Section 309.

To the contrary, while the Directors cite *FDIC v. Castetter*, 184 F.3d 1040 (9th Cir. 1999), for the proposition that the business judgment rule insulates directors from simple negligence, Motion at 7:4-8, the case in fact holds that the California business judgment rule "requires directors to act in good faith and with the prudence that an ordinary person would under like circumstances. However, it also entitles a director to rely on information supplied by others." *Id.* at 1044. The

other case relied on by the Directors, *Ritter & Ritter Pension & Profit Sharing Plan v. Churchill*, 166 Cal. App. 4th 103, 123 (2008) was an action for an injunction against an association, which did not implicate Section 309 or Section 7231.

*Berg & Berg Enters., LLC v. Boyle*, 178 Cal. App 4th 1020 (2008), also holds that the duty of care applies to directors notwithstanding the business judgment rule.[5] The court recognized that the rule does not shield failure to make reasonable inquiry – a breach of the duty of care. *Id.* at 1045. By holding that "***in most cases*** 'the presumption of the business judgment rule can be rebutted only by affirmative allegations of facts which, if proven, would establish fraud, bad faith, overreaching or an unreasonable failure to investigate material facts,'" *id.* at 1046 (emphasis added), the court recognized that failure to investigate is not the only breach of the duty of care actionable under the business judgment rule.

**B. The Business Judgment Rule Does Not Require Enhanced Pleading.**

The Directors suggest that the business judgment rule creates an enhanced pleading standard for claims for damages against directors. Motion at 8:12-14. However, claims for damages against directors are not special matters subject to Fed. R. Civ. P. Rule 9. Rather, such claims are subject to Rule 8(a)(2), requiring a short and plain statement of the claim, and, under *Ashcroft v. Iqbal*, *supra* at 1949, and *Bell Atlantic Corp. v. Twombley*, 550 U.S. 544, 555-56 (2007), requiring further that sufficient factual matter be pled to state a claim for relief that is plausible on its face. *Berg & Berg,* the case relied on by the Directors, reflects these principles (as applied in state court) rather than any enhanced pleading standard. *See* 178 Cal. App. 4th at 1046-7.[6]

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[5] The portion of *Berg & Berg* discussing the business judgment rule is an alternative holding of the case. The primary holding was that directors owe no fiduciary duties to creditors of a corporation in the zone of insolvency other than those imposed by the trust fund doctrine. *Id. at 1041.*

[6] The complaint alleged "not facts but the conclusion that the board simply did nothing by way of investigation of alternatives to the assignment" for the benefit of creditors. *Id.* at 1046. The facts actually alleged in the complaint – the company being

### C. **Application Of The Standard Of Care Is An Issue Of Fact.**

In general, the issues relating to application of the standard of due care are for the finder of fact. Under California law, determining what constitutes due care in any particular case, and whether or not a breach of a duty of due care has occurred, is a question of fact for the jury, which must view the conduct as a whole in the light of all the circumstances. *Brummett v. County of Sacramento,* 21 Cal. 3d 880, 887 (1978); *Laird v. T. W. Mather, Inc.,* 51 Cal. 2d 210, 215-216 (1958). Put differently, it is for the jury to determine: (1) how a reasonably prudent person would have acted under the circumstances presented; and (2) whether the defendant's conduct conformed to that standard. *Laird,* 51 Cal. 2d at 215-216; *see Pool v. City of Oakland*, 42 Cal. 3d 1051, 1061 (1986) (the trier of fact determines whether a defendant's conduct satisfies the applicable standard of care); *Barber v. Chang*, 151 Cal. App. 4th 1456, 1463 (2007) (the elements of breach of duty and causation are ordinarily questions of fact for the jury's determination).

The Directors assert that the business judgment rule requires the Court to focus on the process by which the directors made their decisions rather than the content of the decisions. Motion at 9:16-10:20. Because the business judgment rule insulates directors from liability for prudently made decisions, claims alleging breach of the duty of care must usually consider the decision making process to establish lack of prudence. However, that fact does not render the content of the decision irrelevant, when evaluated as of the time it was made and not in hindsight.

The business judgment rule does not change the inherently factual nature of the standard of care: "as an ordinarily prudent person in a like position would use under similar circumstances." Not surprisingly, therefore, other than *Berg & Berg*,

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in the zone of insolvency and director's knowledge of the alternative to the assignment favored by the plaintiff creditor – "do not, without more, rebut the presumption" of the business judgment rule because directors do not owe a fiduciary duty to creditors when their corporation is in the zone of insolvency and the plaintiff did not plead facts suggesting that the investigation of alternatives would have made the decision to assign for the benefit of creditors unreasonable. *Id.* at 1046-1047.

none of the cases cited by the Directors in which courts dismissed complaints under the business judgment rule sought damages for breach of the duty of care under Corporations Code § 309 or § 7231. *See* Motion at 9:7-14.[7]

Further factual development is particularly important to determine the applicability of the business judgment rule in this case. First, there is very little case law discussing the application of Section 7231 outside of the homeowners association context. Second, the policy considerations relevant to nonprofit mutual benefit corporations differ significantly from those applicable to for-profit corporations under Section 309. For the latter, the business judgment rule "'recognizes that shareholders to a very real degree voluntarily undertake the risk of bad business judgment; investors need not buy stock, for investment markets offer an array of opportunities less vulnerable to mistakes in judgment by corporate officers.'" *Frances T. v. Village Green Owners Ass'n*, 42 Cal. 3d 490, 507 (1986) at n. 14, citation omitted; *Lamden* 21 Cal. 4th at 259. For a for-profit corporation, the essence of the business judgment for directors is deciding how a company will evaluate the trade-off between risk and return, and their ability to earn returns for investors by taking business risks would be crippled by imposing liability on directors for making a "wrong" decision. *See In re Citigroup Inc. Shareholder Derivative Litig.*, 964 A. 2d 106, 126 (Del. Ch. 2009).

The considerations are different for a nonprofit credit union such as WesCorp. WesCorp's members were not investors voluntarily buying shares in WesCorp in hopes that they could profit from the business risks WesCorp took. They were generally small credit unions looking for banking services, a borrowing source and a

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[7] In *Barnes v. State Farm Mut. Auto. Ins. Co.*, 16 Cal. App. 4th 365 (1993), *Lee v. Interinsurance Exchange of the Auto. Club of So. Cal.*, 50 Cal. App. 4th 694 (1996), and *Fairchild v. Bank of America*, 192 Cal. App. 2d 252 (1961), the plaintiffs sought declaratory or injunctive relief to force corporate action. *McMichael v. United States Filter Corp.*, 2001 U.S. Dist LEXIS 3918 (C.D. Cal. 2001), applied Delaware law and invoked the exculpatory clause in the certificate of incorporation. *Id.* at *49. In *Findley v. Garrett*, 109 Cal. App. 2d 166 (1952), the complaint was dismissed for insufficient allegations of fraud.

safe place to keep their excess funds. FAC ¶ ¶ 39, 43. Nor was WesCorp capitalized like a for-profit financial institution. The corporate mandate for its directors was not to earn greater return by taking shrewd investment risk, but to provide effective funds management and services to benefit its members. FAC ¶ 41.

Given WesCorp's nonprofit status and its role of safeguarding its members' funds, the case law applying the business judgment rule to for-profit companies does not completely define the duty of care for WesCorp's directors. The contours of that duty must be developed though an analysis of the facts of the case under the standard imposed by Section 7231.

### D. The First Amended Complaint States A Claim For Breach Of Fiduciary Duty Notwithstanding The Business Judgment Rule.

The facts alleged in the First Amended Complaint and the reasonable inferences that can be drawn from them permit a fact finder to determine that the Directors breached the standard of care prescribed in Section 7231 by: (1) departing from WesCorp's traditional, conservative business model and seeking substantial increases in investment portfolio income, without considering the additional credit risk that WesCorp was taking, or the safeguards or controls that would be required to mitigate it; (2) not considering or informing themselves of the increasing level of risk that was being created in WesCorp's investment portfolio by the increasingly large amounts of investment income the Directors were budgeting; (3) continuing, without further deliberation, to direct WesCorp to obtain higher investment income, even after receiving information in 2005 and 2006 that investment spreads were tightening and that increasingly risky investments were therefore required to obtain the same yield and portfolio income; (4) setting concentration limits for private label MBS that would allow WesCorp to invest its entire portfolio in those securities; (5) not considering the imposition of concentration limits for Option ARM MBS despite the inherent riskiness of the Option ARM collateral on which they were based and the growing concentration of such securities in WesCorp's portfolio; and (6) not

requiring the reporting of the concentration of Option ARM MBS and lower tranche MBS in WesCorp's investment portfolio.

Nothing in the First Amended Complaint establishes as a matter of law that these failures by the Directors to inform themselves, to deliberate about their actions and to set meaningful concentration limits were merely poor outcomes from otherwise prudently-made business judgments. Nothing establishes that they were the result of a diligent decision-making process or that the Directors made reasonable inquiry prior to these acts and omissions. To the contrary, the thrust of the NCUA's allegations is that the Directors failed to exercise the care of an ordinarily prudent person in these acts and omissions. Because nothing in the First Amended Complaint affirmatively establishes that the Directors did not breach the duties prescribed by Section 7231, the First Claim For Relief cannot be dismissed pursuant to Rule 12(b)(6) under the business judgment rule.

### E. <u>The Directors' Assertions Of Pleading Defects Are Meritless.</u>

#### 1. <u>The NCUA Need Not Allege Irrational Or Overreaching Conduct Or Violation Of The Duty Of Loyalty</u>.

The Directors contend that the First Claim For Relief is barred because it "does not allege that the content of Defendants' business decisions was irrational or gross overreaching," Motion at 11:4-5, and because it "does not allege fraud, bad faith or conflicts of interest," Motion at 12:15. Nothing in either the language of Section 7231 or the cases construing it suggests that acts or omissions of directors satisfy the duty of care unless they are irrational or overreaching.[8] The rationality threshold invoked by the Directors was enunciated in *Katz v. Chevron Corporation*, 22 Cal. App. 4th 1352, 1367 (1994), a case applying Delaware law, not California law. "Overreaching" is material to the duty of loyalty, not the duty of care.

[8] Of the two cases cited by the Directors, *Castetter* does not hold or suggest that liability under Section 309 requires proof that directors did not believe that they were acting in the best interests of the corporation, *Id.* at 1044, and *Ritter & Ritter* did not involve damages claims against directors at all. 166 Cal. App. 4th at 125.

Similarly, nothing in Section 7231 requires allegations of fraud, bad faith or conflicts of interest – breaches of the duty of loyalty – in order to state a claim for breach of the duty of care. While the First Amended Complaint does not allege breaches of the duty of loyalty against the Directors, it also nowhere alleges that the Directors "are simply good citizens who tried their best to oversee the management of the money their own credit unions had entrusted to WesCorp." Motion at 12:21-23. Rather, the NCUA expects the evidence to show that some of the directors were CEOs of large sophisticated credit unions that benefited from WesCorp's subsidy of its "back office" services. These facts and the effects of the benefit on the CEOs personally are facts to be developed in discovery. They are not allegations necessary to state a claim for breach of the duty of care.

Notwithstanding the arguments of the Directors, Motion at 11:28-12:8, nothing suggests that the actions of directors of a nonprofit corporation must be secret or unlawful to create liability for breach of the duty of care. There is some limit to the risks that directors can prudently cause a credit union to take. Directors causing those risks are not insulated from liability simply because the risks are not kept secret and do not happen to violate statutes or regulations.

In asserting that all the First Amended Complaint alleges is "a disagreement about . . . how much risk to bear and how much reward to seek," Motion at 11:13-15, the Directors simply ignore the material allegations. In invoking Delaware law governing for-profit corporations to assert that the "core protections" of the business judgment rule are "designed to allow corporate managers and directors to pursue risky transactions without the specter of being held personally liable," the Directors ignore the role of WesCorp as a nonprofit, thinly capitalized service organization for its credit union members.

### 2. **The Directors' Assertions About Their Conduct Raise Issues For Trial, Not This Motion To Dismiss.**

The Directors contend that the "process" allegations in the First Amended Complaint do not overcome the business judgment rule because (1) they do not allege lack of a reasonable inquiry; (2) they admit actions that show the claimed diligence of the Directors, and (3) they do not mention that WesCorp had expanded investment authority and purchased only securities whose ratings were above the minimum ratings permitted under that authority. Motion at 13:1-16:21. These contentions are based on the Directors' selective and restrictive interpretation of the allegations of the First Amended Complaint. They ignore those allegations taken as a whole with all permissible inferences drawn in favor of the NCUA.

Lack of reasonable inquiry can be reasonably inferred from the allegations of the First Amended Complaint. Moreover, it is not the only requirement of the duty of care prescribed in Section 7231. A director must perform his duties "with such care, ***including*** reasonable inquiry, as an ordinarily prudent person in a like position would use under similar circumstances." Subdivision (a), emphasis added.

The "admissions" of Director diligence are largely based on inferences the Directors choose to draw from the allegations, many contradicted by other allegations. Specifically:

(1) Nothing in the First Amended Complaint alleges that the Directors "set, monitored and followed appropriate concentration limits." Motion at 13:16-17. Rather, the First Amended Complaint alleges that WesCorp's concentration limits for private label MBS were not appropriate and that the Board should have imposed concentration limits on Option ARM MBS. Nor does the First Amended Complaint allege that WesCorp ceased MBS purchases long before most on Wall Street. *Id.* 13:19-20. The NCUA expects the evidence to show that purchases ceased only a few months before the market froze for private label MBS.

(2) The First Amended Complaint does not allege that WesCorp "used the bond rating of investments to track tranche positions." *Id.* 13:22-23. To the contrary, the cited paragraphs allege that WesCorp did not track either concentration of Option ARM MBS or concentration by tranche position. While paragraph 72 does allege that WesCorp did not require the latter "except by bond rating," no allegation suggests that bond rating effectively tracks concentration by tranche position. The NCUA expects the evidence to show that it does not.

According to the Directors, the First Amended Complaint does not suggest that WesCorp should have tracked WesCorp's Option ARM and lower-tranche MBS concentrations. Motion at 16:4-7. The NCUA alleges that both forms of MBS were riskier than other MBS; that concentrations of both became significant; and that the losses caused by these investments destroyed WesCorp. FAC ¶ ¶ 59-64, 78. These allegations justify an inference the concentrations should have been tracked.

(3) Despite the Directors' contrary assertions, Motion at 13:24-27, the First Amended Complaint alleges that the budgets contained "very little information about the proposed projected investment income, investment expense and net income interest." FAC ¶ 65. It also alleges that the Directors "were not provided any information about how the composition of WesCorp's investment portfolio would need to change to achieve the net interest income projected in the budgets." FAC ¶ 65.

The Directors characterize these allegations as "nitpicking." Motion at 15:25. Similarly, they minimize the allegations that the directors did not seek or receive critical investment information by asserting that "[e]specially in hindsight, any management report could be improved." Motion at 16:8. Whether the information shortcomings alleged by the NCUA are "nitpicking" and normal institutional imperfections or rather were part of the Directors' fundamental failure to prudently govern the affairs of WesCorp is an issue to be resolved at trial.

(4) The First Amended Complaint does not allege that the Directors "received and considered presentations on Option ARM MBS" or that they took any affirmative steps to adjust WesCorp's investment strategy based on that information, as the Directors contend. Motion at 14:3-6. It alleges that "the Investment Department reported at the ALCO meetings that it was purchasing significant quantities of Option ARM MBS," FAC ¶ 76, and that "WesCorp curtailed its purchase of AA rated MBS." FAC ¶ 77. However, it does not allege that the curtailing of AA MBS purchases was a reaction to the information about large purchases of Option ARM MBS, and the NCUA expects the evidence to show that it was not.

Neither the fact that the ratings on WesCorp's MBS were higher than the regulatory minimums nor the fact that WesCorp was granted expanded investment authority establish that the Directors acted with the prudence required by Section 7231. If anything, the fact that WesCorp sought and was granted permission to take greater investment risk imposed upon the Directors a greater obligation to ensure that that risk was managed prudently. The NCUA policies cited by the Directors, 12 C.F.R. § 703 and 12 C.F.R. § 704, assign the responsibility to enact and enforce prudent investment and concentration policies to credit union directors. While the NCUA is basing its claims against the Directors on their imprudent acts and omissions rather than regulatory violations, the regulations play a role in defining the contours of the Directors' duty of care in this case.

Finally, the Directors mischaracterize the allegations of the First Amended Complaint by asserting that it reflects "condescension about Defendants' understanding." Motion at 16:22-17:2. The allegations the Directors cite allege failure to act and failure to make reasonable inquiry. They allege nothing about understanding. Nor does *Castetter*, the case Directors invoke, hold that lack of understanding is, *ipso facto* protected by the business judgment rule. In *Castetter*, the Ninth Circuit affirmed summary judgment because the FDIC did not rebut the

directors' *prima facie* showing of reasonable investigation, and the allegations that the directors did not comprehend their business were irrelevant to that issue. *Castetter*, 184 F.3d at 1045.

In this case, whether the Directors' actions challenged here were taken in good faith reliance on information provided by WesCorp's officers, "after reasonable inquiry when the need therefor is indicated by the circumstances and without knowledge that would cause such reliance to be unwarranted" will be a disputed issue of fact. The allegations of the First Amended Complaint would permit a fact finder to determine that the challenged acts and omissions of the Directors were not insulated from liability by the reasonable inquiry and good faith reliance provisions of Section 7321.

## II. THE FIRST AMENDED COMPLAINT STATES A CLAIM AGAINST BURRELL FOR NEGLIGENCE.

The First Amended Complaint alleges that Burrell was an Executive Vice President and the Chief Investment Officer for WesCorp and was responsible for WesCorp's investment portfolio and for ensuring that WesCorp's investments earned the returns required to meet its budget for investment income and net interest income. FAC ¶¶ 8, 67. It alleges that as an Officer Defendant, Burrell failed to propose any concentration limits for Option ARM MBS, failed to track and report concentrations of Option ARM MBS and lower tranche MBS in WesCorp's portfolio and thereby failed to provide the board with sufficient information to control concentration risk. FAC ¶¶ 70-71, 73. These alleged facts are sufficient to state a claim against Burrell.

Notwithstanding Burrell's contention, the protection of the business judgment rule does not extend to corporate officers under California law.[9] Both Section 7321

[9] The case relied on by the Directors, *McMichael v. United States Filter Corp.*, 2001 U.S. Dist. Lexis 3918 (C.D. Cal. Feb. 23, 2001) applied Delaware law, not California law.

and Section 309 explicitly apply only to directors. An officer may be liable for conduct that a director would not be liable for, since the premise of the business judgment rule is that disinterested directors are presumably acting in the best interests of the corporation. *See Gaillard v. Natomas*, 208 Cal. App. 3d 1250, 1265 (1989). [See NCUA's Opposition to Siravo and Swedberg's Motion to Dismiss 18:23-19:26.]

## III. THE CLAIM FOR VIOLATION OF 12 U.S.C. § 1787(h) IS VIABLE.

### A. Section 1787(h) Creates An Independent Federal Claim For Damages.

The moving defendants argue that 12 U.S.C. § 1787(h) does not apply in California because (1) California law sets a lower liability standard than gross negligence; and (2) California does not recognize a claim for gross negligence. Motion at 18:14-19:7. Neither argument is supported by authority, and both run contrary to the language and purpose of Section 1787(h).

Section 1787(h) is the credit union analog to 12 U.S.C. § 1821(k), a statute creating a federal gross negligence claim for the FDIC. By its terms, Section 1787(h) permits the NCUA acting as conservator or liquidating agent to bring a federal claim for damages against directors and officers of credit unions for engaging in gross negligence. *See FDIC v. McSweeney*, 976 F.2d 532, 537 (9th Cir. 1992) ("The first sentence of [12 U.S.C.] § 1821(k) authorizes the FDIC to bring claims alleging gross negligence as a matter of federal law").

The moving defendants' argument that Section 1787(h) does not permit such claims in California is based on a sentence in *Atherton v. FDIC*, 519 U.S. 213, 117 S. Ct. 666, 136 L.Ed.2d 656 (1997) stating that 12 U.S.C. § 1821(k) "applies as a substitute for state standards that are more relaxed." *Id.* at 214. That sentence, relating to whether state or federal law sets "the standard of care to measure the legal propriety of the defendants' conduct" does not suggest that the FDIC can only bring Section 1821(k) claims in states with director liability standards more relaxed than gross negligence. *Id.*

The *Atherton* court held that state law simple negligence claims are not preempted by Section 1821(k) because of its savings clause specifying that it does not displace other applicable law. *Atherton* 519 U.S. at 227. If Section 1821(k) or Section 1787(h) simply did not apply when state law imposed a simple negligence standard, there would be no need for the savings clause.

The argument that Section 1787(h) does not apply because California does not recognize any general claim of gross negligence is similarly flawed. As *Atherton* observed, section 1821(k) was enacted to set a gross negligence "floor" in response to concern about state legislatures acting to limit the liability of bank officers and directors. *Id.* at 228-229. Under the moving defendants' interpretation, Section 1787(h) would only set a gross negligence floor in states that recognized gross negligence. It would set no floor at all in any state that (1) imposed a more relaxed standard for director liability than gross negligence and (2) did not recognize a claim of gross negligence. *Atherton* makes clear that this interpretation of Section 1787(h) must be rejected. Moreover, California recognizes gross negligence as a standard of care when it is required by a statute, as it is in this case.[10]

### B. **The Allegations Of The First Amended Complaint Are Sufficient To Plead Gross Negligence.**

California long ago recognized that a director can be liable for gross negligence. *Fox v. Hale & Norcross Silver Min. Co.*, 108 Cal. 369 (1895) (finding that directors who paid little attention to business operations but entrusted the management of the business to the president and superintendent of the company

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[10] While *Continental Ins. Co. v. Am. Prot. Indus.*, 197 Cal. App. 3d 322, 330 (1987), held that the concept of gross negligence as an independent tort claim had ceased to be relevant, it acknowledged that the standard still exists under various statutes. *Id.* at 330. Similarly, in *Saenz v. Whitewater Voyages, Inc.*, 226 Cal. App. 3d 758, 766 n. 9 (1991), the Court stated in dicta that California does not have a direct claim for gross negligence independent of a statutory basis. *Martinez v. United States,* No. EDCV 09-0375-SVW (RC), 2010 US Dist. Lexis 105763, *20-*21 (CD Cal. Mar. 25, 2010) cited the court's holding in *Saenz* and dismissed an inmates claim for gross negligence because no statutory basis had been pleaded. *Id.* at *22.

who abused their trust and caused loss and damage to the company warranted finding of gross negligence). *See also, Burt v. Irvine Co.*, 237 Cal. App. 2d 828 (1965) (citing *Fox* with approval).

California defines gross negligence as: "the lack of any care or an extreme departure from what a reasonably careful person would do in the same situation to prevent harm to oneself or to others." *CACI No. 425. "Gross Negligence" Explained*; *City of Santa Barbara v. Superior Court*, 41 Cal. 4th 747, 754 (2007)(Gross negligence defined in California as either a "want of even scant care" or "an extreme departure from the ordinary standard of conduct"); *accord*, *Van Meter v. Bent Construction Co.*, 46 Cal. 2d 588, 594 (1956);; *Decker v. City of Imperial Beach*, 209 Cal. App. 3d 349, 358 (1989)(gross negligence is merely an extreme departure for the ordinary standard of care.)[11]

The First Amended Complaint states a claim for gross negligence under the California standard of "an extreme departure from what a reasonably careful person would do in the same situation to prevent harm to oneself or to others. It alleges that the conduct of the director defendants alleged to breach their duty of care was also grossly negligent, as was their conduct of essentially ignoring the prospect that real estate values could decline, and allowing and encouraging WesCorp to borrow huge sums of money to invest in private label MBS. FAC ¶¶ 120, 121.

Whether particular conduct constitutes gross negligence is generally a question of fact. *Decker*, 209 Cal. App. 3d at 358. Even when the issue is decided as a matter of law, it is generally in the context of a full factual record. *See e.g. RTC*

[11] The Delaware "recklessness" standard for gross negligence cited by the moving defendants, Motion at 19:19-20:6, as applied in *In re Walt Disney Co. Derivative Litigation*, 907 A. 2d 693, 750 (Del. Ch. 2005) is not the law in California. *Decker*, 209 Cal. App. 3d at 358 (Gross negligence requires want of scant care or extreme departure for ordinary standard of conduct.); *See also*, *City of Santa Barbara*, 41 Cal. 4th at 754, fn. 4 (contrasting "wanton" or "reckless" misconduct with gross negligence). Likewise, the Arizona gross negligence standard cited in *RTC v. Blasdell*, 930 F. Supp. 417, 426 (D. Ariz. 1994) (under Arizona law gross negligence differs from ordinary negligence in quality and not degree differs from California's standard.

*v. Blasdell*, 930 F. Supp. 417, 426-427 (D. Ariz. 1994) (Summary judgment granted because evidence presented by RTC did not support gross negligence finding, particularly in light of testimony of RTC's expert). Although the moving defendants contend that the allegations they have culled and interpreted do not amount to gross negligence, the allegations of the First Amended Complaint taken as a whole would permit that finding.

The First Amended Complaint alleges that the acts and omissions of the moving defendants caused the failure of the largest retail corporate credit union in the United States. Whether the alleged conduct was an extreme departure, a departure, or no departure at all from what a reasonably careful person would do to prevent harm to others cannot be determined on the face of the complaint. It must be evaluated based on the evidence presented in this case. The motion to dismiss this claim should be denied.

## IV. THE STATUTES OF LIMITATIONS DO NOT BAR ANY CLAIMS.

### A. The Limitations Period For The First Claim For Relief Is Four Years.

The NCUA had three years from imposition of the WesCorp conservatorship in March 2009 to bring this action, provided the limitations period had not already run at the time the institution was closed. *See* 12 U.S.C. § 1787(b)(14)(B)(i); *FDIC v. McSweeney,* 976 F.2d 532, 534 (9th Cir. 1992); *FDIC v. Former Officers & Directors of Metro. Bank,* 884 F.2d 1304, 1309 n. 4 (9th Cir. 1989). As the moving defendants concede, the statute of limitations governing this action against directors and officers for breach of their duties to the corporation is the four year limitation period prescribed by California's "catch-all" statute, Code of Civil Procedure § 343. Motion at 22:22-24. *See, McSweeney* 976 F.2d at 536; *Lehman v. Superior Court,* 145 Cal. App. 4th 109, 113 (2006) (applied Section 343 to breach of fiduciary duty claim against directors).

The claims against the officers and directors accrued at the time the questionable securities were purchased. *See FDIC v. Jackson,* 133 F.3d 694, 696-

697 (9th Cir. 1998) (limitations period begins to run when questionable loan is made). Since the NCUA's claims are based on purchases of private label MBS in 2006 and 2007, and the conservatorship was imposed in 2009, the claims are timely.

**B. The Statute Of Limitations Does Not Bar The Section 1787(h) Claim.**

The Directors argue that the Second Claim For Relief is subject either to California's two year state statute of limitations for negligence claims or its three year statute for liabilities created by law. Motion at 22-24. Because 12 U.S.C. § 1787(h) is a federal statutory claim, however, its limitations period is established by federal law, not by California law. *King v. United States*, 301 F.3d 1270, 1277 (10th Cir. 2002); *Bunnell v. Department of Corrections*, 64 Cal. App. 4th 1360, 1369 (1998); *LLP Mortg. v. Bizar*, 126 Cal. App. 4th 773, 777-78 (2005). The applicable statute of limitations is set forth in 12 U.S.C. § 1787(b)(14), which provides that the limitations period for any tort claim brought by the NCUA as conservator or liquidating agent shall be three years after the claim accrues and that the claim accrues upon appointment of the Conservator.

While Section 1787(b)(14) cannot resurrect claims that were time-barred as of the date of conservatorship, this rule does not apply to the NCUA's claim under Section 1787(h). The "no-resurrection" rule is based on the principle that an assignee cannot obtain any greater rights through assignment than the assignor had. *See FDIC v. Former Officers & Directors of Metro. Bank*; *Guaranty Trust Co. v. United States*, 304 U.S. 126, 142, 58 S.Ct. 785, 82 L.Ed. 1224 (1938). The rule applies to any claim the NCUA acquired from WesCorp as a matter of law pursuant to 12 U.S.C. § 1787(b)(2)(A). However, the Section 1787(h) claim was never owned by WesCorp or transferred to the NCUA, since it can be brought only by the NCUA acting as conservator or liquidating agent. Since the claim did not accrue until the conservatorship came into existence in 2009, the statute of limitations on it does not run until three years thereafter.

## CONCLUSION

For the reasons set forth above, the NCUA respectfully requests that the motion to dismiss brought by the Directors and Burrell be dismissed.

DATED: November 22, 2010

LUCE, FORWARD, HAMILTON & SCRIPPS LLP
MICHAEL H. BIERMAN
MICHAEL E. PAPPAS

By: /s/ Michael H. Bierman
Michael H. Bierman
Attorneys For The National Credit Union Administration Board As Conservator For Western Corporate Federal Union

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